

ACTION ON DECISION

IRB No. 2010-22
June 1, 2010

Subject: Tidewater Inc. and Subsidiaries and Tidewater Foreign Sales Corporation v. United States, 565 F. 3d 299 (5th Cir. 2009), aff'g No. 06-875, 2007 U.S. Dist. LEXIS 77147 (E.D. La. October 17, 2007)

Issue:

Whether certain time charters entered into between members of Taxpayer's controlled group and unrelated customers are leases under I.R.C. § 7701(e).

Discussion:

Tidewater Inc. and certain of its subsidiaries ("Taxpayer") own ocean-going vessels used in the offshore energy industry in foreign and domestic waters. For tax years 1998-2000, Taxpayer bareboat chartered the vessels to certain of its operating company subsidiaries. Taxpayer and the Service agree that the bareboat charters were leasing transactions. In turn, the operating companies time chartered the vessels to unrelated customers. Each time charter obligated the operating company to provide the customer with a named ocean-going vessel with certain capabilities and a crew to operate that vessel for a specified period of time.

Taxpayer and the Service disagreed about whether the commissions paid to Tidewater FSC (a foreign sales corporation ("FSC") under former § 922) in connection with the charters qualified for the preferential FSC tax treatment under former §§ 921-927. If the time charters with the unrelated customers were subleases of the vessels, the commissions qualified for the preferential FSC tax treatment; otherwise, if the time charters were contracts for services, the commissions did not qualify. See former I.R.C. § 927(a)(2)(A) and Temp. Treas. Reg. § 1.927(a)-1T(f)(2).

Taxpayer claimed that the time charters constituted subleases of the vessels for purposes of the FSC provisions. The Service disagreed and concluded that the time charters were not leases.

The district court rejected the Government's position that the FSC provisions require an "all or nothing" characterization of the time charters as either a lease or a service contract. Tidewater Inc. v. United States, No. 06-875, 2007 U.S. Dist. LEXIS 77147, at 13-14 (E.D. La. October 17, 2007). The court determined that the time charters were, in part, subleases and granted the Taxpayer's motion for summary judgment. The court failed to apply (or even discuss) the factors listed under § 7701(e) for determining

whether an agreement is a lease. The case was appealed to the United States Court of Appeals for the Fifth Circuit.

The Fifth Circuit adopted the Government's "all or nothing" approach to characterizing transactions for purposes of the FSC provisions: each time charter must be characterized as either a lease or a service contract for purposes of the FSC provisions. The court also agreed with the Service that § 7701(e) provides the proper framework for that determination. Section 7701(e) provides that all relevant factors should be taken into account to determine whether a contract is properly treated as a service contract or a lease, including whether or not (A) the service recipient is in physical possession of the property, (B) the service recipient controls the property, (C) the service recipient has a significant possessory or economic interest in the property, (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and (F) the total contract price does not substantially exceed the rental value of the property for the contract period.

The Fifth Circuit agreed with the Government that the operating company bore the risk of loss if anything happened to the vessel, was responsible for costs of the vessel's maintenance, insurance, and any other costs associated with the crew, and bore the risk of diminished receipts for each day the vessel was not in use, and that the price of a time charter exceeded the base rental value of the vessel because the price factored in sums attributable to the crew and other operating expenses. The court also agreed that the operating company's employees operated the vessel (demonstrating physical possession) and that control of the operation, maintenance, and repair of the vessel remained in the hands of the operating company. The court acknowledged that these factors weighed in favor of characterizing the time charter as a service contract.

The Fifth Circuit, however, determined that the customer had the type of constructive possession and control over the vessel typically associated with a lease. Despite all of the factors supporting characterization of the time charters as service contracts, the court concluded that the control exercised by the customers was so significant that it made the time charters more like leases than service contracts. The court affirmed the district court's order granting the Taxpayer's motion for summary judgment.

The Service agrees that § 7701(e) provides the proper framework for determining whether a particular time charter is a lease transaction. However, the Service disagrees with the way the Fifth Circuit applied the "physical possession" and "control" factors of § 7701(e) to the facts in this case. The mere right to direct the destination and itinerary of voyages for a specific time period is not sufficient to conclude that the time charters at issue should be treated as leases of property rather than contracts for services. The Fifth Circuit acknowledged that most of the factors in § 7701(e) support the characterization of the time charters in this case as service contracts. Therefore, the time charters should be treated as service contracts.¹

¹ The Service notes that the time charters at issue in Tidewater would be treated as producing income

Recommendation: Nonacquiescence

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from services for other purposes of the Code (for example, the passive foreign investment company provisions under §§ 1291-1298). As income from services, however, such income may still constitute either transportation income under § 863(c) or income from space or ocean activities under § 863(d) and sourced accordingly.

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